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C O N F I D E N T I A L SECTION 01 OF 02 RIGA 000166

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TAGS: ECON EINV EFIN PGOV LG
SUBJECT: LATVIA: DEVALUATION UNLIKELY BUT INVESTORS NERVOUS

Classified By: Ambassador Catherine Todd Bailey, for Reasons 1.4 (b) an
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¶1. (U) Summary. Three weeks of debate on whether Latvia will need to devalue its currency has left investors nervous. While key players agree that the risk of devaluation remains remote, they also agree that serious concerns exist regarding Latvia's macroeconomic situation. Talk of devaluation and the downgrading of Latvia's outlook by Standard & Poor's may give the government political cover to make tough decisions, but it remains to be seen if the political will exists for the government to take on vested interests and implement unpopular measures to combat inflation and cool the overheated economy. End of Summary.

Finally noticing the Check Engine light

¶2. (U) A three-week public discussion on the state of the Latvian economy has left markets and investors nervous. The spark of the debate was a February 10 article in the leading newspaper Diena by Morten Hansen, Head of the Economics Department at the Stockholm School of Economics in Riga. Latvian media previously expressed concern about Latvia's inflation rate, which at close to 7% last year was the EU's highest, but this was generally outweighed by reports of Latvia's EU-best GDP growth, higher wages and low unemployment. The Hansen article changed the focus of the debate by characterizing devaluation of the Lat, the national currency, as a credible possibility.

So how bad does it look?

¶3. (U) General warnings about Latvia's overheating economy are nothing new. Local press has for some time debated anti-inflation measures and the advisability of moving forward with large public building projects. A January 12 Economist article laid out all the worrisome statistics: GDP growth up to 12% annually, home prices rising by 2% per month, a current account deficit at a whopping 24% of GDP, and real wage growth vastly outstripping productivity gains. The article made a dire forecast- that the inflationary pressures likely if GDP growth continued growing in excess of 10% could lead to a hard landing and economic stagnation in Latvia. The forecast of problems to come was muted by a prediction that Latvia's growth was likely to slow to 7% annually in 2007-11. The article downplayed the possibility of a devaluation, and made it clear that the Bank of Latvia's strong credibility made such a move unlikely. (Hansen himself told PolEcon Off separately that he shared the Economist's views).

So if we all agree, why are we still talking?

¶4. (C) Devaluation concern touches Latvian society to a greater degree than talk of inflation and overheating because of one simple factor - almost all lending in Latvia is done in Euros. Everyone, from the biggest oligarch to young Latvians trying to pay their huge mortgage and consumer loan bills, knows that if they end up needing more lats to pay the same euro-denominated loans, they are in deep trouble.

¶5. (U) If the Hansen article weren't enough to rattle investors, Latvians were treated to a series of related events. At first the news was calming, with Diena newspaper running a follow-on article on February 13 on how most experts agree that the risk of lat devaluation remained trivial, and printing on February 16 a column from the Governor of the Bank of Latvia, Ilmars Rimsevics, in which he promised that the Bank will not devalue while he's in charge.

¶6. (C) The calm was short lived. The weekend of February 17-18 saw a run of people trying to sell lats for euros. The run, which according to Rimsevics was an orchestrated scare using cell phone text messages to spread rumors of imminent devaluation, led some small currency-exchange businesses to run out of euros. The Interior Ministry promptly opened an investigation (stating that they would pursue the rumor instigators with possible economic sabotage charges that carry 5 to 12-year jail sentences).

¶7. (U) This was followed by Standard and Poor's February 19 announcement that they were lowering Latvia's outlook from stable to negative, based on the increased likelihood of a hard landing. More bad news hit on February 21 with reports that the interest rates on the RIGIBOR inter-bank money market index had risen from around 5% to almost 9%, reportedly caused by devaluation rumors and Scandinavian

investors trying to decrease their risks from lat devaluation by increasing loans in lats.

¶8. (U) The latest jolt came from the Financial Times, whose March 1 article reported that the Danish bank Danske Bank had issued an analysis which compared Latvia's economic situation to that of Asian countries before the 1997 crisis. Danske Bank's chief economist, Carsten Valgreen, was quoted predicting that a crisis in Latvia could "trigger contagion across the fast-growing Baltic states of Estonia and Lithuania and into eastern Europe".

Government Response

¶9. (C) Aside from Rimsevics' February 16 article, the main government response has been to speed up the release of recommendations from a task force that the Finance Ministry organized last year to develop anti-inflation proposals. Rimsevics indicated in a January meeting with the Ambassador that the task force recommendations would be ready in April, but the Finance Ministry subsequently announced the findings will be presented to the Cabinet of Ministers on March 6.

¶10. (C) Given that the lat is pegged to the euro, thus eliminating monetary policy options to fight inflation, media speculation about the task force's recommendations focus on fiscal policy measures - new taxes on real estate transactions and reassessing the cadastral value of properties, delaying large public building projects, and running a government budget surplus. The key interest among analysts and investors, though, is not so much what measures are suggested, but whether there is the political will to implement the recommendations.

Will the government act?

¶11. (C) In the course of the last three weeks, PolEcon Off

has heard similar worries from Hansen and Rimsevics that the government has not recognized the necessity of curbing Latvia's excessive GDP growth and accompanying inflation. PolEcon Off met with the Standard and Poor's analysts who authored the recent outlook change when they visited Riga on February 8, and they said that during their 2006 meetings in Riga they noted that the GOL had no interest in tackling its macroeconomic problems, but understood the attitude given that parliamentary elections were looming. The analysts expressed dismay, however, that their 2007 meetings with government officials post-election had displayed a continued lack of interest in the subject.

¶12. (C) Both Hansen and Rimsevics said they did not know if the government would accept taxes on real estate transactions, given that so many key figures in Latvian political life have significant financial interests in real estate and continuation of the status quo would be beneficial to those holdings. Hansen also remarked that increasing taxes across the board would be unpalatable to the government as there is a degree of tax competition among the Baltic states.

Implications for the US and the road forward

¶13. (C) Comment: Having the Latvian economy hit with a hard landing or a devaluation of the lat would have only marginal economic impact on American interests. Only one bank in Latvia is American-owned and any decrease in bilateral trade and investments between Latvia and the US would not be significant from the perspective of the huge US economy. The main negative impact to the US would be the possible tightening in Latvian government resources to expend on such items as foreign assistance, a diminution of Latvia's pro-free market voice in the EU and, if Danske Bank's analysis is correct, the combined spillover effect into the economies of other allies in the Baltics and Eastern Europe. To avoid this economic crisis, most agree that the GOL must act soon to curb growth and inflation. The recent statements by Standard & Poor's and Danske Bank give the government political cover to enact measures that would have been difficult to support three weeks ago. If the government can tighten spending and begin to curb real estate speculation, it could influence the economy towards a more sustainable trend long-term. End Comment.
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